

# CAPITAL REVENUE FORECAST

## MAJOR CAPITAL REVENUES

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### Overview

The major revenues that support the City of San José's capital programs are bond proceeds, grants, transfers between funds, and a number of taxes levied on construction and property resale (conveyance) activity. This document provides a five-year forecast for the following taxes and fees: Construction and Conveyance Tax; Building and Structure Construction Tax; Construction Excise Tax; Residential Construction Tax; Sanitary Sewer Connection Fee; and the Storm Drainage Connection Fee.

As shown below, these revenues are expected to generate \$247.9 million over the next five years, a decrease of 4% over the 2008-2012 Adopted Capital Improvement Program (CIP) estimates. The Construction-Related Revenue chart included at the end of this section provides a year-by-year comparison of this forecast with the 2008-2012 Adopted CIP.

### Forecast Comparison Summary

(\$ in Thousands)

	2008-2012 CIP	2009-2013 Forecast	Difference	Change
Construction and Conveyance Tax	127,000	121,000	(6,000)	(5%)
Building and Structure Construction Tax	50,167	48,396	(1,771)	(4%)
Construction Excise Tax	72,203	70,026	(2,177)	(3%)
Residential Construction Tax	1,124	990	(134)	(12%)
Sanitary Sewer Connection Fee	6,305	5,599	(706)	(11%)
Storm Drainage Connection Fee	1,566	1,906	340	22%
<b>TOTAL</b>	<b>258,365</b>	<b>247,917</b>	<b>(10,448)</b>	<b>(4%)</b>

For the Construction and Conveyance Tax, the Conveyance Tax portion (property transfers) account for 98% of the total collections. The decline in the number of real estate transactions led by the recent sub-prime lending tightening continues to negatively impact collections. While a decline in Construction and Conveyance Tax revenues was predicted in the development of the 2008-2012 Forecast, recent information (October 2007 decline of 52% and December 2007 decline of 44%) indicates that collections have dropped quicker and further than previously anticipated, and likely will not improve in the near-future. Collections through January 2007 represented drops in 19 of the past 21 months when comparing to collections in the same month of the prior year. As a result, in this Forecast this category is projected to generate \$121 million over the next five-years, a decrease of \$6 million from the estimates assumed in the 2008-2012 Adopted Capital Improvement Program (CIP). The average annual collection level of \$24.2 million projected in the 2009-2013 Forecast is also well below the actual collection levels in recent years that reached a peak of \$49 million in 2005-2006 but is expected to drop to \$27 million in 2007-2008.

# CAPITAL REVENUE FORECAST

## MAJOR CAPITAL REVENUES (CONT'D.)

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### Overview (Cont'd.)

The capital revenue projections for the other taxes and fees described in this forecast are derived from construction activity estimates provided by the Planning, Building and Code Enforcement (PBCE) Department. Each year the PBCE Department provides projections of activity for each of the three types of development (residential, commercial, and industrial) from which the revenues are derived. A more complete discussion of these estimates is provided in a technical report prepared by that department entitled "Development Activity Highlights and Five-Year Forecast (2008-2013)", which is attached as an appendix to this document.

Over the forecast period, PBCE projects construction activity to remain relatively flat with valuation hovering around \$1 billion in each of the next five years. These assumptions are slightly below those presented in the 2008-2012 Forecast. Construction activity peaked in 2000-2001 at \$1.9 billion, followed by a sharp decline that reached a low point of \$796 million in 2003-2004 (adjusted to 2007 dollars). From that low point, a modest recovery occurred in 2004-2005 with growth of 13% in that year. However, in 2005-2006, construction activity dipped again, to \$797 million, primarily due to a fall off of multi-family development to a ten-year low. A modest rebound driven primarily by commercial and industrial development and residential high rise construction in the downtown area occurred in 2006-2007 and is expected to continue in 2007-2008 and run through 2008-2009. This activity is then expected to flatten out at \$1 billion and peak in 2010-2011, with slight decreases in activity projected for 2011-2012 and 2012-2013. Based on the construction activity estimates and a review of revenue collection patterns, a decrease in construction-related taxes and fees of \$10.4 million, or 4%, is expected when comparing the 2009-2013 Forecast to the 2008-2012 Adopted CIP estimates.

Each of the six revenue categories along with a discussion of the major construction activity trends are discussed in more detail below.

### CONSTRUCTION AND CONVEYANCE TAX

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The Construction Tax portion of the Construction and Conveyance Tax category is levied on most types of construction. For residential construction, the tax rate is based upon the number of units constructed and ranges from \$75 per unit located in a building containing at least 20 dwelling units to \$150 for a single-family residence. The commercial and industrial rate is eight cents per square foot of floor area constructed. The Construction Tax accounts for approximately 2% of the total Construction and Conveyance Taxes collected.

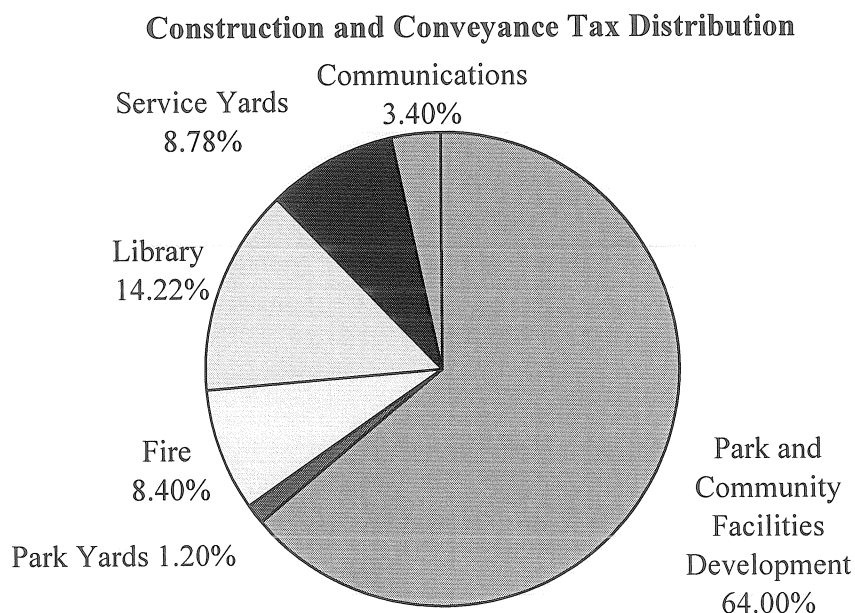
The Conveyance Tax portion of the Construction and Conveyance Tax category is imposed upon each transfer of real property where the value of the property exceeds one hundred dollars. The tax is imposed at a rate of \$1.65 for each \$500 of the value of the property. The Conveyance Tax accounts for approximately 98% of the total Construction and Conveyance Taxes collected.

# CAPITAL REVENUE FORECAST

## CONSTRUCTION AND CONVEYANCE TAX (CONT'D.)

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Construction and Conveyance Tax receipts are allocated using the following distribution to capital programs.



Under the current City ordinance, the combined proceeds from the Construction and Conveyance Tax may be used for facility acquisition, construction, equipment, furnishings, and limited operating and maintenance expenses.

Consistent with the Construction and Conveyance Tax Task Force recommendations adopted by the City Council in June 1989, the Park and Community Facilities Development portion of the estimated revenues, less non-construction costs and transfers to the General Fund, is allocated for all years of the forecast using a two-to-one ratio, with two-thirds of the proceeds going to neighborhood/district projects and one-third to city-wide projects. Per the current City Council policy, 20% of funds for neighborhood/district projects is set aside and equally allocated to meet special needs. The balance of the funds is then distributed based on a formula using the following criteria:

- neighborhood and community-serving park acres per 1,000 population;
- developed neighborhood and community-serving park acres per 1,000 population;
- square feet of neighborhood and community-serving center space per 1,000 population; and
- developed park acres and/or facilities in good condition per 1,000 population.

The five-year projection for Construction and Conveyance Tax revenue totals \$121 million, a decrease of \$6 million from the \$127 million estimated in the 2008-2012 CIP. The Construction and Conveyance Tax revenue projections are based upon: 1) a review of prior year collection trends; 2) a review of year-to-date residential sales activity in San José; 3) a review of year-to-date tax receipts; and 4) projections of the future strength of the San José real estate market.

# CAPITAL REVENUE FORECAST

## CONSTRUCTION AND CONVEYANCE TAX (CONT'D.)

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- **Prior Year Collection Trends**

Historically, Construction and Conveyance Tax revenues have been very volatile, reflecting the impacts of the ups and downs of the local economy. In the late 1980's, collections of this tax were relatively strong, peaking at \$18 million in 1988-1989. In the first half of the 1990's, however, revenue fell precipitously with collections ranging from approximately \$9.3 million to \$11 million annually, reflecting the economic slowdown experienced at that time. In the latter half of the 1990's, healthy annual increases were again realized in this revenue category with growth skyrocketing from \$13.4 million in 1995-1996 to a peak of \$31.6 million in 2000-2001. This tremendous growth was indicative of the economic gains during that period, marked by stock market growth, low unemployment, and gains in personal income. As economic conditions began to worsen, tax receipts in this area fell, experiencing a 17% decline in 2001-2002 to \$26.3 million and an additional 5.5% decline in 2002-2003 to \$24.8 million. Surprisingly, this drop-off did not continue, even though the general economic conditions did not improve significantly. Far exceeding our projections, collections grew to \$38.2 million in 2003-2004 and reached a record setting high of \$49 million in 2005-2006. Collections in 2006-2007 began to fall, as correctly predicted, declining to \$41.8 million following the recent real estate slowdown and sub-prime credit tightening.

- **2007-2008 Collections**

As projected in the 2008-2012 Forecast, the extreme distress in both the national and local real estate markets has seen collections of the Construction and Conveyance Tax plummet from the peak levels two years ago. Collections received in January 2008 constituted the 19<sup>th</sup> out of the past 21 months where tax proceeds fell when comparing to collections in the same month of the prior year. Construction and Conveyance Tax collections in 2007-2008 of \$15.8 million through January 2008 decreased approximately 26% from the prior year. Data received in the most recent months (52% drop in October 2007 and 44% drop in December 2007) are particularly alarming, causing concern that these revenues may not have yet reached bottom. Performance for a number of key indicators supports this notion. The number of property transfers for all types of residences in the city has decreased by an astounding 44% through January 2008 when compared to the same period last fiscal year. Similarly, the average days on market for residential properties has steadily grown from 67 days in January 2007 to 74 days in January 2008. Finally, after months of not experiencing the drop in values seen in most other areas of California, the median single-family home price of \$664,000 in January 2008 finally reflected a drop; a 4.7% decline compared to the \$697,000 figure in January 2007.

Despite the extreme drop in the real estate market, it is still anticipated that Construction and Conveyance Tax receipts will meet the \$27 million level adopted in the current CIP, which assumed an approximate decline of 35% from the collection level of \$41.8 million received in 2006-2007.

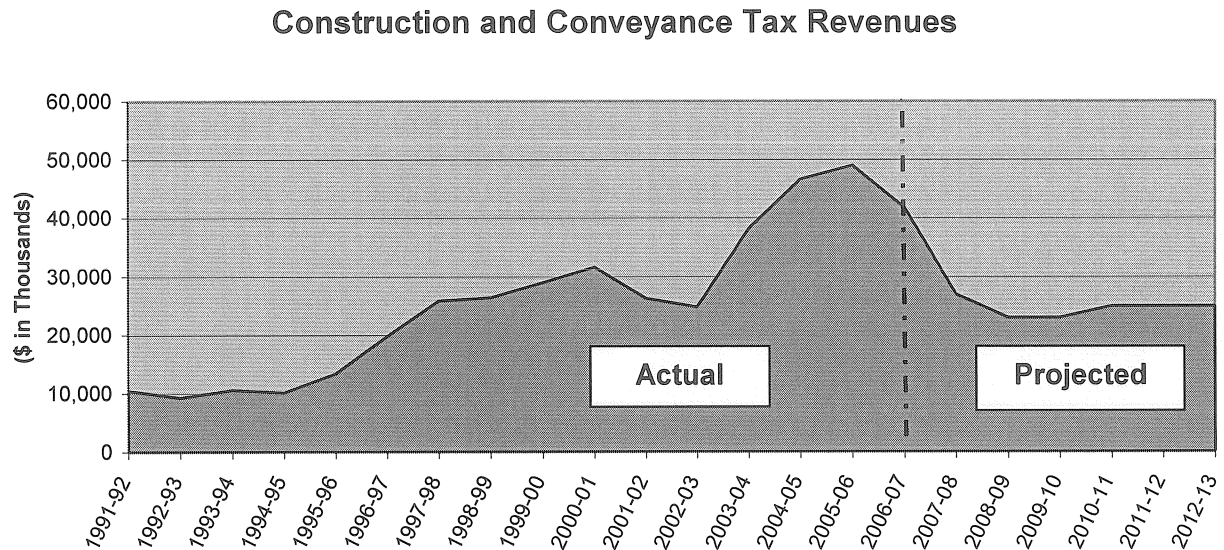
# CAPITAL REVENUE FORECAST

## CONSTRUCTION AND CONVEYANCE TAX (CONT'D.)

- **2009-2013 Collections**

The 2009-2013 Construction and Conveyance Tax revenue forecast is built on the assumption that collections will continue to decline, reflecting a continuation of the extreme slowdown of the local real estate market, with collections falling again to \$23 million in 2008-2009 and 2009-2010, and finally rising slightly to a collection level of \$25 million annually for the three remaining years of the forecast. This forecasted collection level reflects what is believed to be a more sustainable level of ongoing housing resale activity.

The following graph illustrates the volatility of this revenue source through a display of actual and projected revenues for the combined Construction and Conveyance Tax revenues over a 20 year period:



## CONSTRUCTION ACTIVITY PROJECTIONS

With the exception of the Construction and Conveyance Tax Fund, the capital revenues described in this forecast are construction-related taxes and fees. As described above, the PBCE Department has provided construction activity projections for each of the three types of development (residential, commercial, and industrial) from which the revenues are derived. These construction activity estimates are described in a report prepared by that department entitled "Development Activity Highlights and Five-Year Forecast (2008-2013)", which is attached as an appendix to this document.

# CAPITAL REVENUE FORECAST

## CONSTRUCTION ACTIVITY PROJECTIONS (CONT'D.)

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A summary of the PBCE Department construction activity projections and the corresponding revenue estimates are provided below. It should be noted that due to the highly volatile nature of the construction market, the reliability of the estimates can be expected to decline over the period of the forecast. The Department intends these to be interpreted as “ball park” estimates of the most likely state of the local economy based on current information. As new information becomes available, these estimates will be refined.

### A. Residential Construction Activity

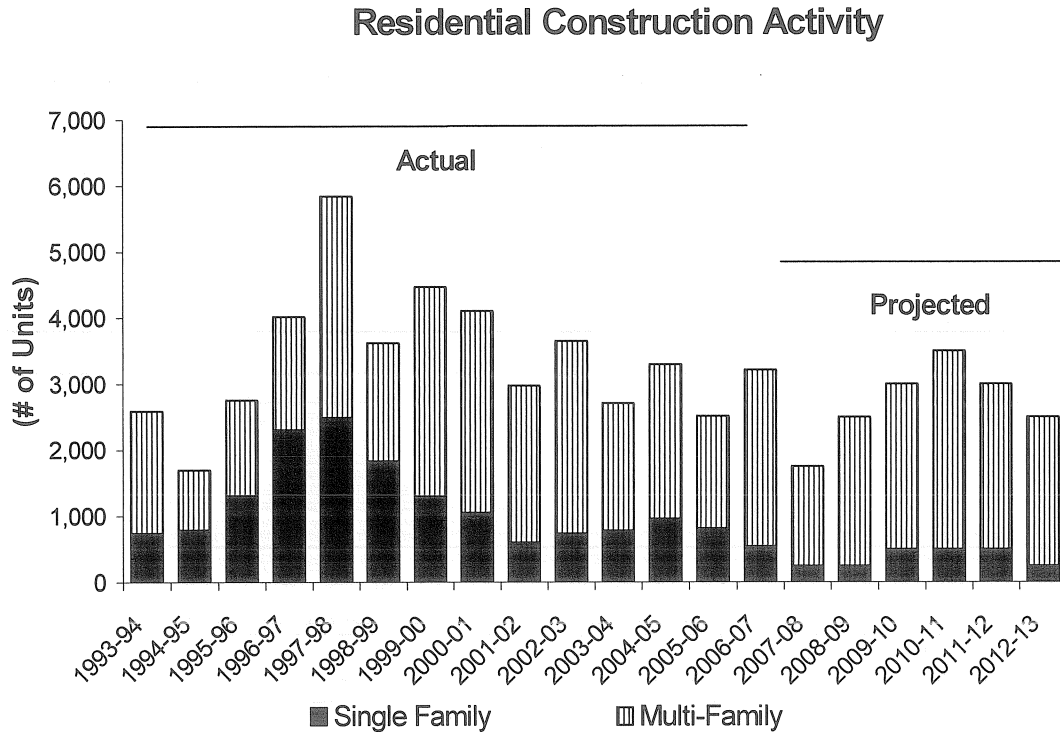
A significant portion of development-related revenue in San José has traditionally been generated by residential construction. Permit activity in 2006-2007 in this sector showed improvement compared to the prior year, with building permits issued for 3,214 new dwelling units. This represented an increase of 28% from the 2005-2006 totals of 2,515 entirely due to an increase in multi-family construction activity, primarily in the downtown area. Of this increase, multi-family building permits issued rose by 57% from 1,701 units in 2005-2006 to 2,669 units in 2006-2007. This more than offset the 33% decline in single-family permits issued which fell from 814 units in 2005-2006 to 545 units in 2006-2007. In 2007-2008, however, the real estate slowdown is expected to have a significant negative impact on the number of permits issued, with a decrease to an estimated 1,750 new units.

PBCE does expect residential construction activity to generate a total of 14,500 units over the five-year period, an average of 2,900 units per year. This activity level represents a slight increase, expected to be driven entirely by the multi-family market, compared to the 2,600 units per year estimate included in the 2008-2012 Forecast. This activity level, however, represents a significant decline from the actual levels experienced in recent years, which reached a high of 5,842 units in 1997-1998.

Reflecting a continuing trend of mid- and high-rise housing construction in downtown and North San José, a total of 14,500 multi-family units are expected to be constructed over the next five years, an increase from the 11,500 multi-family units projected in the 2008-2012 Forecast. In this Forecast, reflecting an expected decline in home prices, rising inventory, and credit tightening; only 2,000 new single-family dwellings are anticipated. This figure is actually, however, an increase from the 1,500 anticipated in the 2008-2012 Forecast, however, a significant decrease from the 4,250 anticipated in the 2006-2010 and 2007-2011 Forecasts. The following chart shows the number of units, by housing type, anticipated in San José through 2012-2013.

# CAPITAL REVENUE FORECAST

## CONSTRUCTION ACTIVITY PROJECTIONS (CONT'D.)



### B. Commercial Construction Activity

In 2006-2007, commercial construction activity totaled \$214 million, a slight decrease from the 2005-2006 level of \$211 million but a huge drop (72%) from the peak reached in 2000-2001 of \$765 million. Planning staff expects commercial activity to experience only moderate increases in 2007-2008, with permit valuation estimated to reach \$350 million.

Over the forecast period, commercial construction is expected to stay flat at \$350 million in 2008-2009 and decrease slightly with anticipated valuations of \$325 million through the remainder of the five-year period represented in the forecast (see the chart in section C on the following page). The total commercial valuation projected in this forecast is \$1.65 billion, which is just slightly above the \$1.6 billion estimated in the previous five-year forecast. As discussed in the attached report provided by the Planning, Building and Code Enforcement Department, the outlook for commercial construction activity is moderate but stable with pending applications for a major expansion of the Valley Fair Shopping Center, and expected development in the downtown and North San José areas in support of the new housing growth in those areas.

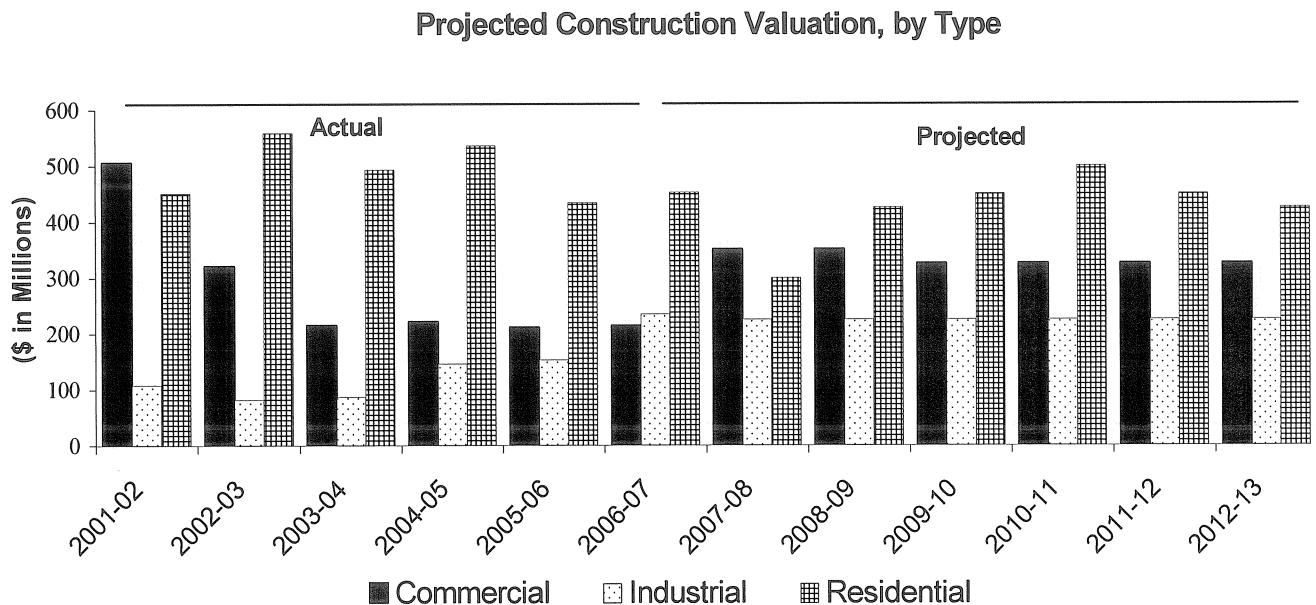
# CAPITAL REVENUE FORECAST

## CONSTRUCTION ACTIVITY PROJECTIONS (CONT'D.)

### C. Industrial Construction Activity

Industrial construction activity in San José has experienced a dramatic decline since the peak in 2000-2001. In 2002-2003, permit valuation reached a low point of only \$82 million, a precipitous drop from the peak of \$531 million in 2000-2001. In 2004-2005, a slight recovery was experienced with permit valuation reaching \$146 million and continued to grow to \$235 million in 2006-2007. A modest decline is expected, with permit valuation projected to reach \$225 million in 2007-2008 and remain flat throughout each of the five-years in the Forecast. The total industrial valuation over the forecast is estimated at \$1.13 billion, which is slightly below the \$1.35 billion estimated in the last forecast. As discussed in the attached report provided by the Planning, Building, and Code Enforcement Department, activity in this area is expected to remain modest over the forecast period. Various concerns, including slowing employment growth, high energy costs, and waning business and consumer confidence have placed uncertainty over the prospects for near-term expansion of industrial space. Until this uncertainty begins to dissipate, property owners are unlikely to venture much beyond relatively limited investments in existing buildings.

The following graph illustrates the level of projected construction activity by type (not including exemptions).





# CAPITAL REVENUE FORECAST

## MAJOR DEVELOPMENT ACTIVITY DATA

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As part of the attached Development Activity Highlights and Five-Year Forecast (2008-2013) document prepared by the Planning, Building and Code Enforcement Department, information is provided on development activity that serves as the foundation for their forecast. Data is provided on the major projects (residential projects greater than 50 units, commercial projects greater than 25,000 square feet, and industrial projects greater than 75,000 square feet) and is broken down by the three major land use categories – residential, commercial, and industrial. The projects are further subdivided into four categories based on their status (completed, under construction, approved but not yet commenced, and pending City approval). In addition, individual maps are provided for each of the 15 planning areas in the City that show the projects in all status categories submitted since January 1, 2004. These maps can be used in conjunction with the activity data to help analyze the rate, type and location of major development activity in San José.

## BUILDING AND STRUCTURE CONSTRUCTION TAX

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The Building and Structure Construction Tax is imposed upon the construction, repair or improvement of any building or structure where a building permit is required. Current rates are:

- 1) Residential -  $1\frac{3}{4}\%$  of 88% of the Building Official's valuation.
- 2) Commercial -  $1\frac{1}{2}\%$  of the Building Official's valuation.
- 3) Industrial - 1% of the Building Official's valuation.

The proceeds from the Building and Structure Construction Tax are restricted by ordinance for use for traffic capital improvements on major arterials and collectors. These improvements can include the acquisition of land and interest in land and the construction, reconstruction, replacement, widening, modification and alteration (but not maintenance) of City streets. This tax revenue provides the Traffic Capital program with funds to complete major street infrastructure projects, particularly those that improve the Level of Service (LOS). LOS refers to the efficiency with which streets and roadways accommodate peak level traffic.

Based on the construction activity forecasts supplied by the PBCE Department and an analysis of actual collection patterns, the five-year projection for the Building and Structure Construction Tax collections totals \$48.4 million, with annual proceeds ranging from \$8.7 million to \$10.0 million. The five-year revenue projection represents a decrease of approximately \$1.8 million (3.5%) from the estimate included in the 2008-2012 Adopted CIP. While collections are expected to improve slightly over the forecast period, the lower projected activity levels reflect the current uncertainty in the residential real estate market and are still well below the peak levels experienced a few years ago. For instance, the 2007-2008 revenue estimate of \$8.8 million for this tax is a drop of almost 50% from the actual receipts in 2000-2001 of \$17.4 million.

A comparison of the five-year forecast with actual collections in previous years for the Building and Structure Construction Tax is shown in the chart in the following section.

# CAPITAL REVENUE FORECAST

## CONSTRUCTION EXCISE TAX

The Construction Excise Tax (also referred to as the Commercial-Residential-Mobile Home Park Building Tax) is imposed upon the construction, alteration, repair or improvement of any building or structure, which is for residential or commercial purposes or is associated with a mobile home. This general purpose tax may be used for any “usual current expenses” of the City. However, the City Council has historically used the majority of these funds for traffic improvements. The current rates are:

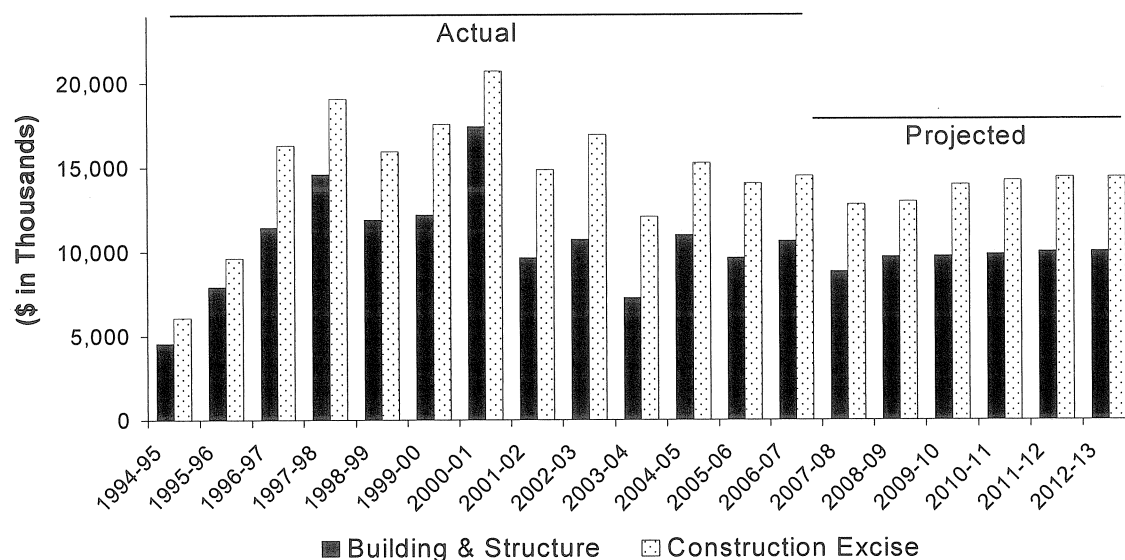
- 1) Residential -  $2\frac{3}{4}\%$  of 88% of the Building Official's valuation.
- 2) Commercial - 3% of the Building Official's valuation.

Unlike the Building and Structure Construction Tax, this tax does not apply to industrial development. As a result, changes in industrial building activity do not affect these tax receipts.

This tax is a general fund tax that can be used for any purpose. The majority of the proceeds have generally been used for a variety of essential Traffic Capital projects that cannot be funded by the Building and Structure Construction Tax or grants. Typical projects funded with this tax include street maintenance and resurfacing, streetlights, bicycle and pedestrian facilities, and most strategic planning programs, which improve the City's ability to obtain State and federal grants. A portion of these taxes have also been regularly used to help balance General Fund problems during times of financial stress on that fund.

Based upon the construction projections provided by the PBCE Department and actual collections on this tax, Construction Excise Tax collections are projected to total \$70.0 million over the five-year forecast period. This collection level also represents a small decrease of \$2.2 million (3.0%) from the 2008-2012 Adopted CIP. This decrease reflects the assumptions that the real estate slowdown will impact residential development in the near-term, recovering slightly over the remainder of the forecast period.

### Major Construction-Related Tax Revenues



# CAPITAL REVENUE FORECAST

## RESIDENTIAL CONSTRUCTION TAX

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The Residential Construction Tax is imposed upon the construction of residential dwelling units and mobile home lots in the City. The rates are imposed on each dwelling unit and differ according to the number of units located in the building. Rates vary from \$90 for each dwelling unit in a multiple dwelling of at least 20 units to \$180 for a single-family residence.

This tax is collected and placed in the Residential Construction Tax Contribution Fund and is used to reimburse developers that have constructed a wider arterial street than their residential development required. The funds are also used to construct median island landscaping and other street improvements.

Based upon construction estimates by the PBCE Department and the actual collection pattern for this tax, \$990,000 in revenue is expected over the five-year period of this forecast. This amount is slightly below the 2008-2012 Adopted CIP revenue estimates of \$1.1 million.

## SANITARY SEWER CONNECTION FEE

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The Sanitary Sewer Connection Fee is charged for connecting to the City's sewer system. The fees collected may only be used for the construction and reconstruction, including land acquisition, of the San José sanitary sewer system. The fee is based on the number of single and multi-family residential units built and the acres developed on commercial and industrial properties.

The 2009-2013 projection for this fee is \$5.6 million, which is an 11.2% overall decrease from the 2008-2012 CIP estimate of \$6.3 million. In addition to being affected by the lack of a significant rebound in development activity, this category is particularly impacted by a drop in the amount of projects involving undeveloped parcels for which these fees are assessed. Property that is being redeveloped typically is not subject to the fee.

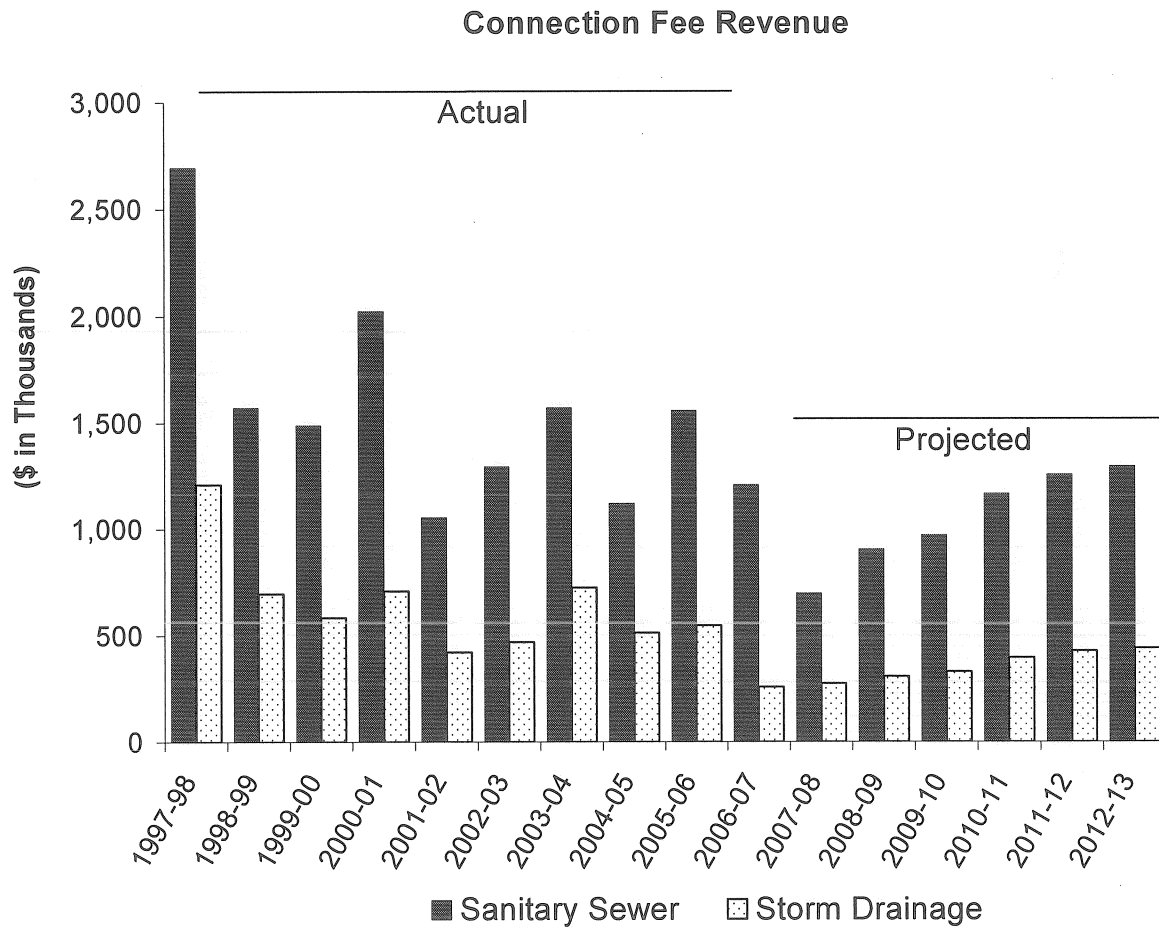
## STORM DRAINAGE CONNECTION FEE

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The Storm Drainage Connection Fee is charged to the owner of any land that discharges storm water, surface water or ground water runoff into the City's storm drainage system. The fees are charged by acreage or lot and vary by land use and by the number of units located in the development. Storm Drainage Connection Fees may only be used for the construction, reconstruction, land acquisition and maintenance of the San José storm drainage system. The five-year forecast for Storm Drainage Connection Fees is \$1.9 million, which is a slight increase from the estimate of \$1.6 million included in the 2008-2012 CIP. Over the five-year forecast period these fees are projected to rise from \$309,000 in the first year of the forecast period to \$441,000 in the fifth year.

# CAPITAL REVENUE FORECAST

## STORM DRAINAGE CONNECTION FEE (CONT'D.)



# Construction-Related Revenue

2009 - 2013

(in \$ thousands)

	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	5 Yr Total
<b>Construction and Conveyance Tax</b>							
2008-2012 ADOPTED CIP	27,000	25,000	25,000	25,000	25,000	N/A	127,000
2009-2013 FORECAST	27,000	23,000	23,000	25,000	25,000	25,000	121,000
<b>Difference</b>	-	(2,000)	(2,000)	-	-	N/A	(6,000)
<b>Building and Structure Construction Tax</b>							
2008-2012 ADOPTED CIP	10,183	9,996	9,996	9,996	9,996	N/A	50,167
2009-2013 FORECAST	8,839	8,705	9,753	9,873	10,023	10,042	48,396
<b>Difference</b>	(1,344)	(1,291)	(243)	(123)	27	N/A	(1,771)
<b>Construction Excise Tax</b>							
2008-2012 ADOPTED CIP	14,779	14,356	14,356	14,356	14,356	N/A	72,203
2009-2013 FORECAST	12,800	12,975	13,974	14,223	14,415	14,439	70,026
<b>Difference</b>	(1,979)	(1,381)	(382)	(133)	59	N/A	(2,177)
<b>Residential Construction Tax</b>							
2008-2012 ADOPTED CIP	256	217	217	217	217	N/A	1,124
2009-2013 FORECAST	100	150	211	206	211	212	990
<b>Difference</b>	(156)	(67)	(6)	(11)	(6)	N/A	(134)
<b>Sanitary Sewer Connection Fee</b>							
2008-2012 ADOPTED CIP	1,215	1,235	1,254	1,274	1,327	N/A	6,305
2009-2013 FORECAST	700	907	972	1,167	1,257	1,296	5,599
<b>Difference</b>	(515)	(328)	(282)	(107)	(70)	N/A	(706)
<b>Storm Drainage Connection Fee</b>							
2008-2012 ADOPTED CIP	304	309	314	319	320	N/A	1,566
2009-2013 FORECAST	275	309	331	397	428	441	1,906
<b>Difference</b>	(29)	-	17	78	108	N/A	340
<b>TOTAL</b>							
2008-2012 ADOPTED CIP	53,737	51,113	51,137	51,162	51,216	N/A	258,365
2009-2013 FORECAST	49,714	46,046	48,241	50,866	51,334	51,430	247,917
<b>Difference</b>	(4,023)	(5,067)	(2,896)	(296)	118	N/A	(10,448)